Specialized Accounting

Unit 4

Introduction

An individual i.e., a sole proprietor may not be in a position to cope with the financial and managerial demands of a present-day business world. As a result, two or more individuals may decide to pool their financial and non-financial resources to carry on a business.

As per **Section 4** of the **Partnership Act, 1932**:

“Partnership is the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all.”

Persons who have entered into partnership with one another are called individually partners and collectively a firm and the name under which their business is carried on is called the firms name.

Essential Elements of Partnership:

a) **Two or more Persons:** There must be at least two partners in a partnership firm.
b) **Agreement:** Partnership is an agreement between partners. The agreement may be written, or it may be verbal also.
c) **Business:** Partnership is formed for doing business.
d) **Sharing of Profits:** Profit and loss of the partnership firm will be divided in the partners in their profit sharing ratio.
e) **Mutual Agency:** The business of the partnership firm may be carried by all the partners or any of them acting for all.

Number of Partners:

Minimum Partners: Two

Maximum Partners: Section 464 of the **Companies Act, 2013**, no association or partnership consisting of more than 100 number of persons as may be prescribed shall be formed for the purpose of carrying on any business. **Rule 10 of Companies (incorporation) Rules 2014** specifies the limit as 50. Thus, **maximum number of members in a partnership firm are 50.**

Partnership Deed

A partnership is formed by an agreement. This agreement may be express (i.e., oral or in writing) or implied. Though the law does not expressly require that the partnership agreement should be in writing, it is desirable to have it in writing in order to avoid any dispute with regard to the terms of the partnership. The document which contains the term of a partnership as agreed among the partners is called ‘partnership deed’. The deed is required to be duly stamped as per the Indian Stamp Act, 1889 and duly singed by all the partners. The partnership deed contains various provisions relating to various matters such as:

a) Name of the firm.
b) Names and addressed of all partners
c) Nature and place of business
d) Date of commencement of partnership
e) Duration of partnership

f) Amount of capital of each partner
g) Profit sharing ratio
h) Interest on capital
i) Interest on drawings
j) Interest on loan advanced by a partner to the firm
k) Salary or commission payable to any partner
l) Method of valuation of goodwill and other assets and liabilities in case of admission or retirement or death of a partner
m) Settlement of accounts in case of retirement/death of a partners dissolution of firm

Rules applicable in the absence of partnership deed:

1. Profit sharing ratio will be equal.
2. No partner is entitled for interest on capital.
3. No interest on drawings will be charged from the partners.
4. If any partners have advanced to the firm, he is entitled to receive interest at the rate of 6% per annum.
5. No partner is entitled for salary, bonus and commission etc.

Partnership accounting: Just like any other business books of accounts are maintained in the firm. In partnership firm capital account of each partner is maintained separately. Following methods are used for maintaining partners' capital account.

1. **Fixed capital method:** In this method the capital of the partners will be fixed in the books of accounts. To maintain the fixed balance of capital a separate account that is partners current account is opened. Interest on capital, interest on drawings, salary, profit and loss etc are shown in current account.
2. **Fluctuating capital account method:** In fluctuating capital account the balance will be changed every year. In this method Interest on capital, interest on drawings, salary, profit and loss etc are shown in capital account.

Profit and loss appropriation account: This account shows the distribution of profits amongst the partners, any transaction which is not recorded in profit and loss account and appropriation of profit.

Guarantee of profit to the partners: Sometimes a new partner is entered in a firm with a guarantee of profit. If his share of profit is less than the guaranteed amount. The new partner gets the guaranteed amount of profit. This difference of profit is borne by the guarantor. The guarantor may be the firm or any partner.

Admission of a New Partner

When a new partner joins a partnership the old partnership is dissolved, and a new partnership is formed. Accounting for admission of new partner depends on the nature of arrangement between the existing partners and the new partner. Such an arrangement can take any of the following forms:

- The new partner brings in new assets
- The new partner purchases interest in partnership from existing partners at book value
- The new partner pays a bonus for the partnership's goodwill; and
- The new partner receives a bonus for the partnership's negative goodwill.

Need for Admission of a New Partner

A new partner may be admitted for any one or more of the following reasons:

- For procuring more capital for expanding business.
- For acquiring more ability for efficient management and administration of business.
- For looking after the increased business of the firm.
- For progress of the firm.
- For reducing competition.
- For various other reasons.

Problems at the Time of Admission of a Partner

1. Determination of new profit sharing ratio and sacrificing ratio at the time of admission of new partner.
2. Valuation and accounting of goodwill of the firm.
3. Revaluation of the assets and liabilities of the firm.
4. Transfer of reserves, undistributed profit and profit and loss of the firm.
5. Writing off of fictitious assets of the firm.
6. Adjustment of capital or calculation of old partners capitals on the basis of new partners capital account.
7. Calculation of new partner capital on the basis of old partners' capital jointly.
8. Adjustment of joint life insurance policy.

In partnership business, at the time of admission of a new partner he is paid a certain share out of the total profit. Thereafter, the remaining profit is distributed to the old partners. The profit sharing ratio of the old partners is changed due to the admission of new partner.

Meaning of New profit Sharing Ratio: The ratio calculated to distribute the future profits of the partnership business among all the partners (old & new) is known as new profit sharing ratio. On the admission of a new partner, the old partners sacrifice a part of their profit in favour of new partner.

New Profit Sharing Ratio = Old Profit Sharing Ratio – Sacrificing Ratio

Meaning of Sacrificing Ratio: The old partners either jointly or any of the partner individually may sacrifice a share of their profit in order to give a share of profit to the new partner.

Sacrificing Ratio = Old Profit Sharing Ratio – New Profit Sharing Ratio

Use of Sacrificing Ratio: It is necessary to determine the sacrificing ratio of the old partners at the time of bringing goodwill in cash by the new partner because the cash brought in by the new partner in form of goodwill has to be distributed among the old partners sacrificing ratio. If only a single partner has sacrificed his share of profit in favour of new partner then the entire amount of goodwill brought in cash will be received by him.

Goodwill

Goodwill is an intangible fixed asset by which business organization attains a position to earn excess earnings in future. Goodwill is created by various factors and its form and value may vary in difference trades and even in different business of the same trade. In short, 'Capacity to earn additional profit is termed as Goodwill'.

Characteristics

Generally, goodwill has following characteristics:

i. Goodwill is an intangible fixed asset.
ii. Goodwill can't be touched or seen but can be fell.
iii. Value of goodwill depends upon the name and popularity of business.
iv. Goodwill is created by various elements.
v. It can't be separated from business.
vi. It is created along with business, and it comes to an end with closure of business.
vii. Sound goodwill attracts customers, it increases their business contacts.
viii. In fact, goodwill is not a fictitious asset as it can purchased or sold like any other asset.
ix. Goodwill depends upon the position of business, owner reputation, capabilities of employees, popularity of product and good name of business.
x. It is marketable asset.

Types of Goodwill:

- **Cat Goodwill:** The nature of cat is place specific. The goodwill related to place is called Cat goodwill.
- **Dog Goodwill:** the nature of dog is to be faithful to his master. So, the goodwill created because of the personality or ability of a person is called dog goodwill or personal goodwill.
- **Rat Goodwill:** A rat changes the place frequently. The goodwill formed due to the temporary attraction of the customers is called Rat goodwill.
- **Rabbit Goodwill:** A rabbit does not like to go far from his place. So, the goodwill created on account of attitude of customers is called rabbit goodwill.

Factors affecting value of Goodwill:

1. Place of Business
2. Nature of Business
3. Risk and uncertainty of Business.
4. Monopolistic Business
5. Management of Business
6. Personality of Businessmen
7. Volume of Capital
8. Popularity of Trademark
9. Volume of profit.
10. Other factors like: Government policy, License policy, National peace, conditions of market, Consumerism, Purchasing power of customers, etc.

Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business takeover, the excess should be termed as goodwill. Thus,

1. Only purchased goodwill to be recorded in the books of accounts.
2. Non purchased goodwill (Self-generated goodwill) will have to be adjusted through partners' capital accounts. Hence, this goodwill now cannot be shown in balance sheet of partnership business.

Methods of Valuation of Goodwill

Partnership deed requires the disclosure of method used for valuation of goodwill. Goodwill can be valued by any one of the following methods:

1. Average Profit Method:

Goodwill = Average Profit × Number of Years of Purchase

2. Super Profit Method:

Average profit of the firm is compared with the normal yield on the invested capital in the firm. Excess of average profit over normal yield or profit is known as super profit.

Super Profit = Actual profit – Normal profit
Goodwill = Super profit × No. of years purchased

3. Annuity Method:

If a firm is making super profits, it is estimated as to how many years firm will continue to get this super profit. Present value of super profits of these years is found out by Annuity Method.

Goodwill = Super profit × Present Value of Re. 1 by Annuity Method

4. Capitalization Method:

Average profits are first capitalized on the basis of normal rate of return, and then excess of this capitalized amount over net assets of the firm is goodwill.

Goodwill = super profit/normal rate of return × 100

Revaluation Account

When a new partner is admitted sometimes revaluation is made of all the assets and liabilities of the old firm. Excesses and deficits of assets and liabilities are transferred to an account known as Revaluation Account or Profit and Loss Adjustment account.

Memorandum revaluation account: Sometimes the new firm wants to show the assets and liabilities of the firm at their old values. In such cases memorandum revaluation account is opened. This account has two parts. In the first part the entries for revaluation are passed and the profit or loss transfer to old partner's capital account. In second part entries are passed to neutralize the revaluation made in the first part and the balance transfer to all partners in new profit sharing ratio.

Retirement of a Partner

According to section 32 of Indian Partnership Act, 1932, a partner may retire from partnership (a) with consent of all other partners (whether implied or expressed); or (b) in accordance with an express agreement by the partners; or (c) conveying his intention to retire (in case of partnership at will) by a written notice.

When a partner wants to leave the firm due to any of the following reasons then it is termed as retirement from partnership:

a) Due to a disease or physical weakness.
b) Due to old age.

c) Due to dispute with any partner.
d) A desire to do some more profitable business or work.
e) Due to any other reason by which he doesn't want to continue in partnership.

Calculation of Total Amount Payable to Retiring Partner

In order to determine the total amount due to retiring partner, his capital account is prepared on the date of his retirement. Retiring partner is entitled to get his share of interest out of the following items or following items are recorded in credit side at his capital account after writing the amount of his capital as per balance sheet:

i. His share in total goodwill of the firm at the date of retirement.
ii. His share in undistributed profit, profit and loss account (credit balance), reserve, reserve fund, general reserve, etc. shown in liabilities side of balance sheet.
iii. His share in profit in case of revaluation of assets and liabilities of the firm on the date of retirement as reflected by profit & loss Adjustment Account or Revaluation Account.
iv. Any interest on his capital, salary, commission, remuneration, etc. either due or outstanding.
v. His share in estimated net profit from the last balance sheet date till the date of retirement.
vi. His share in surrender value of Joint Life Insurance Policy.

Following items are recorded in the debit side of retiring partners' capital account at the time of retirement:

i. His share in profit and loss account as shown in assets side of balance sheet.
ii. His share in loss in case of revaluation of firm's assets and liabilities on the date of retirement as reflected by profit & loss Adjustment Account or Revaluation Account.
iii. His drawings and interest on drawings.
iv. His share in net estimated loss from last balance sheet date till the date of retirement.

Problems at the Time of Retirement of a Partner

At the time of retirement of a partner following accounting problems require adjustments:

1. Calculation of Goodwill.
2. Accounting of Goodwill.
3. Revaluation of assets and liabilities of the firm.
4. Transfer of reserve, undistributed profit and profit and loss account to capital a/c.
5. Writing off fictitious assets.
6. Adjustment of capital.
7. Adjustment of joint life insurance policy.
8. Payment in instalments.

Gaining Ratio: Ratio in which continuing partners receive share of retiring partners is called gaining ratio. Gaining ratio can be determined by subtracting old profit and loss sharing ratio from new profit and loss sharing ratio.

Gaining Ratio=New Profit & Loss Sharing Ratio – Old Profit & Loss Sharing Ratio

Gaining ratio is calculated after retirement or death of a partner in partnership firm. In case of retirement, it is necessary to calculate gaining ratio for opening goodwill account with the share of retiring partner or accounting for goodwill without opening goodwill account.

Treatment of Goodwill: Application of Accounting Standard-10

"According to Paragraph-16 of Accounting Standard-10, 'In case of admission or retirement or death of a partner or in case of change in profit sharing ratio among partners, Goodwill Account cannot be raised in the books of firm because no consideration in money or money's worth is paid for it. Goodwill can be recorded in the books only when some consideration in money or money worth has been paid for it. Therefore, only purchased Goodwill should be recorded in the books of account".

Retiring partner gets his share in his profit and loss sharing ratio in internally generated inherent goodwill of the firm. According to Accounting Standard-10, goodwill will be shown in books of accounts only if cash is paid in consideration of goodwill. According to this Standard, goodwill will be recorded in the books of accounts by the share of retiring partner through remaining partners' capital accounts. In no case goodwill account can be raised.

Adjustment of Joint Life Policy

Meaning of Joint Life Policy: Joint Life Policy means that life insurance policy which is taken by partnership firm on joint life of all the partners from Life Insurance Corporation. The sum insured on such policy is paid by the Life Insurance Corporation on the expiry of period of policy of term or on death of any partner, whichever is earlier.

At the time of retirement of partner, partnership firm enquires about the surrender value of Joint Life Policy from Life Insurance Corporation. Surrender value refers to that value which will be paid by Life Insurance Corporation on surrendering the policy to LIC before completion of term of policy or at the time of insured being alive. Thereafter, Partnership firm make entry for adjustment of surrender value at the time of retirement of any partner.

Death of Partner

Man knows that death is inevitable but when he does not know. Any partner may die any time in partnership firm. After his death, partnership firm continues to operate business as per provisions laid down in partnership deed. In fact, death of a partner dissolves the partnership but it results in reconstitution of the partnership firm.

In case of death of a partner, his executor is eligible to receive the amount due to deceased partner from partnership firm. It is already prescribed in partnership deed that how the amount due to deceased partner will be calculated and how it will be paid. In absence of partnership deed, section 37 of Indian Partnership Act, 1932 is applied.

Death of a partner from accounting point of view implies permanent retirement. Thus, all entries, adjustments and accounting rules which are followed at the time of retirement are also applied in case of death of partner. It also includes problems as to share of profit for the period between last balance sheet date and the date of death of partner along with share in joint life policy. These are discussed in detail in this chapter.

Calculation of Total Amount Payable to the Executors of the Deceased Partner

In case of death of a partner, amount due to executors is calculated and journal entries are made, and books of accounts are maintained in the same manner as in case of retirement.

In partnership firm, executors of deceased partner are authorized to receive payment of following items (these items are written in the credit side of the capital account of deceased partner):

1. Credit balance of capital and current accounts of deceased partner.
2. His share in total goodwill (calculated on the date of death).
3. His share in undistributed profit (retained earnings), profit & loss account, reserve, reserve fund, general reserve etc. shown in liabilities side of balance sheet.
4. His share in profit on revaluation of assets and liabilities at the date of death.
5. If interest on capital, salary, commission, remuneration, etc. is outstanding or due to him.
6. His share in net estimated profit for the period between balance sheet date and date of death.
7. His share in joint life policy.
8. Loan given to partnership firm and interest due thereon.

Following items are subtracted while calculating amount due to executors of deceased partners:

1. Debit balance of capital or current accounts of deceased partner.
2. His share in undistributed accumulated loss or profit-loss account shown in assets side of balance sheet.
3. His share in loss of revaluation of assets and liabilities at the date of death.
4. Drawings and interest on drawings on deceased partner.
5. His share in firm's net estimated loss for the period between last balance sheet date and date of death.
6. Loan given to deceased partner by firm and interest due thereon.

Dissolution of Partnership Firm

The dissolution of partnership between all the partners of a firm is called the dissolution of the firm. In the case of dissolution of a firm, the business of the firms is closed down and its affairs are wound up. The assets are realized, and the liabilities are paid off.

Model of dissolution of firm –

1) **Dissolution without the intervention of the court**
   a) Dissolution by agreement
   b) Compulsory dissolution
   c) Dissolution on the happening of certain contingencies.
   d) Dissolution by notice
2) **Dissolution by the court**
   a) Insanity
   b) Permanent incapacity
   c) Misconduct
   d) Breach of agreement
   e) Transfer of interest
   f) Loss in business
   g) Just and equitable

Steps in the dissolution process:

Step 1	Prepare a balance sheet of the firm as on the date of the dissolution of the firm.
Step 2	Realize the non-cash assets which are not acceptable for distribution in their present form, pay the debts of the firm to third parties. Realization account is prepared to calculate the loss or profit on realization of assets and settlement of liabilities. Loss or profit on realization of assets and settlement of liabilities is transferred to partners' capital accounts.

Step 3	Pay the amount due to each partner rateably for advances (or Loan)
Step 4	Pay the available cash to the partners.

Accounting treatment on dissolution of firm:

In case of dissolution of firm, the following accounts are prepared to close the books of the firm:

1. Realisation Account
2. Partners' loan account
3. Partners' capital account
4. Cash or bank account

1. **Realisation Account:** This is a special type of account. It is a **nominal account**. The purpose of preparing this account is to find out the result of realization of assets and discharge of liabilities.

2. **Partner's loan Account:** This are transferred to the credit side of realization account and the payments there of are shown on debit side of realization account. Alternatively, the payment can be credited directly to cash account.

3. **Partner's capital accounts:** All the reserved and undivided profit or loss, realization profit or loss, balance of current accounts. Now the difference is adjusted in cash if there is credit balance it is surplus to be withdrawn by the concerned partner from their personal resources. Entry for surplus withdrawn or deficiency brought in by the concerned partner from their personal resources.

4. **Cash account:** At first opening balance is written. Then cash at bank is also transferred to this account. Amount realized from assets and deficiency brought in by partners is debited to this account and payment of liabilities, realization expenses and surplus withdrawn by partners are credited. Now both side of cash account will be equal. The agreement of both the sides of cash account is the cross checks of accounting and arithmetical accuracy.